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Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, DC 20554

In the Matter of Section 272(f)(1) Sunset of the BOC Separate Affiliate and Related Requirements	**WC Docket No. 02-112**
2000 Biennial Regulatory Review Separate Affiliate Requirements of Section 64 1903 of the Commission's Rules	**CC Docket No. 00-175**

Reply Declaration

of

LEE L. SELWYN

on behalf of

AT&T Corp.

July 28, 2003

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REPLY DECLARATION OF LEE L. SELWYN

Introduction

Lee L Selwyn, of lawful age, declares and says as follows

1 My name is Lee L Selwyn, I am President of Economics and Technology, Inc. ("ETI"), Two Center Plaza, Suite 400, Boston, Massachusetts 02108 I submitted a Declaration in this matter on June 30, 2003, on behalf of AT&T Corp ("AT&T").

2 In this Reply Declaration, I respond to the Comments and accompanying Declaration submitted by Verizon, SBC, and Qwest, and the Comments of BellSouth in this proceeding. The BOCs contend, generally, that dominant carrier regulation is unwarranted, unnecessary, and

unduly burdensome. Each relies upon the long distance market share then held by AT&T at the time that the Commission had determined AT&T to be non-dominant. Although generally ignoring their own local monopoly, the BOCs claim that competition, price caps, and economic theory prevent a BOC from engaging in cost-shifting or predatory pricing behavior. As I shall demonstrate herein, the BOCs' attempt to draw an analogy between the market and service conditions being confronted by AT&T at the time it was determined to be non-dominant and those applicable to the BOCs' long distance businesses today is inapposite, and their various other claims are without merit.

Summary

3. As I will discuss below, the BOCs' continuing dominance and control of the local bottleneck affords them both the incentive and the ability to engage in anticompetitive conduct, including predatory pricing and discrimination, and unless constrained by affirmative regulatory oversight will ultimately and inevitably result in BOC remonopolization of the long distance market. The static condition of AT&T's market share at the time that the Commission had found AT&T to be non-dominant was only one of the attributes of AT&T that led to the Commission's determination. Unlike the BOCs today, in 1995 AT&T controlled no bottleneck facilities. AT&T had no ability to raise its rivals' costs. AT&T was not a dominant local exchange carrier — indeed, AT&T was not any *sort* of local exchange carrier. If the 1995 condition of AT&T is to serve as a basis for assessing the BOCs' dominance vs. non-dominance at the present time, then the BOCs must be prepared to accept and to adopt for themselves *all* of the substantive

attributes that characterized AT&T in 1995. They would need to accept permanent separation of their local and long distance operations They would need to forego joint marketing and bundling of local and long distance services They would need to accept balloting for diversification of local service shares They would need to accept separate ownership of their long distance and local exchange service businesses. Those changes in the BOCs' status would create comparability between the AT&T of 1995 and the BOCs of 2003 and beyond. Short of that, there is no basis for or merit to the suggestion that the factors considered by the Commission when conferring non-dominant status upon AT&T have any relevance to the appropriate policy for the BOCs

4 The analysis of the BOCs and their declarants is based upon selective considerations of markets — including complete disregard for the market definitions traditionally used by this Commission and suggested by the FNPRM The BOCs intermittently ignore and minimize both their local and long distance market share and market share growth in an attempt to distract the Commission from the *fact* that the BOCs are amassing in-region residential market shares of more than 60% after only a few years in the business. The BOCs and their declarants disguise such market share figures in aggregate business and consumer shares, or in nationwide shares that are intended to conceal their formidable in-region, in-footprint concentration. Through the selective citing of analyst reports coupled with the convenient omission of the BOCs' own reported results and projections, the BOCs have here attempted to mislead the Commission as to the actual and projected state of long distance competition both currently and in the not-too-distant future

5 That the BOCs have acquired these overwhelming long distance market shares is a direct result of their dominance in the local market Through various accounting sleights-of-hand, the BOCs have the ability to shift the burden of marketing, customer acquisition and other costs to their captive local customers, and to ignore access costs that competing stand-alone IXCs must pay, thus creating the ingredients for imposing a price squeeze upon nonaffiliated rivals and, more generally, for pervasive predatory pricing The BOCs' and their declarants assert the oft-repeated claim that "predation is rarely a profitable strategy." That view, however, is rooted in the patently incorrect *assumption* that the BOCs would be unable to recover their current losses from predation through higher rates in the future, because were they to attempt to raise prices once rivals exited the market, the rivals would immediately reenter and push BOC prices down This theory would require, at a minimum, (a) that rivals would immediately reenter the market (after having exited it) as soon as the BOCs attempted to increase prices in the future, thereby foreclosing post-predation profit recoupment, or (b) that the BOCs have no ability to *cross-subsidize* current predatory pricing initiatives with excess profits generated by other BOC services In reality, of course, *neither one of these prerequisite conditions exists*. There is almost no likelihood that investment capital would be made available to finance any consequential IXC reentry initiative, particularly in light of the enormous customer acquisition costs that any reentry attempt would necessarily face together with the threat of a repetition of a BOC predation strategy following such reentry Indeed, this is precisely the sort of game theory perspective that Prof Carlton and his Chicago School colleagues overlook when claiming that successful predation would be impossible Moreover, by limiting their focus to the seemingly abundant interexchange network capacity that presently exists, Carlton *et al* ignore the much

larger component of reentry costs — the *reacquisition of customers who will have switched to the BOC* for their long distance service and the continuing obstacles that an IXC that is not also offering local exchange service would face when competing with BOC bundled local/long distance packages

6 The BOCs rely upon the presence of price cap regulation as ostensibly precluding the opportunity for cross-subsidization of competitive services by excessive monopoly service rate levels, but that presupposes (a) that the price adjustment mechanisms in state and FCC price cap plans have been correctly specified. and (b) that once placed in operation, the price cap schemes are cast in stone and are never reviewed or revised based upon actual performance Neither of these assumptions are correct Ultimately, the tools of dominant carrier regulation would do nothing to remove the *incentive* of the BOCs to shift costs between regulated and unregulated entities, nor the incentive to drive competitors out of the market. Access charge reform and meaningful and nationally available facilities-based local competition are the only way such incentive would be minimized. What dominant carrier regulation would provide is the tools necessary for the Commission and other interested parties to evaluate a BOCs' allocation of costs between local and long distance services, and to compare these allocated costs to specific long distance and bundled local and long distance prices so as to determine that BOCs are pricing these competitive services in excess of cost. Without granular, service-by-service cost allocation, the Commission will have no way of enforcing Section 272(e)(3) or of ensuring that the BOCs are not engaging in a sustained price-squeeze.

The analogy that the BOCs seek to draw as between their existing long distance market share and that of AT&T in 1995 when it was declared non-dominant is superficial and inapposite.

7 SBC, Qwest, BellSouth and Verizon all seek to draw an analogy between their current share of the long distance market and that controlled by AT&T back in 1995, when the Commission reclassified AT&T as a *non-dominant* long distance carrier.[1] As they see it, the BOCs today have a smaller share of the long distance market than AT&T held at the time that it was classified as non-dominant, so on that basis the BOCs should now be declared non-dominant with respect to long distance services following the sunset of the Section 272(a) separate affiliate requirement The Commission should not be misled into accepting this utterly superficial comparison as a basis for the policy determination at issue in this rulemaking proceeding.

8 There are, in fact, a number of fundamental differences between the market conditions facing AT&T back in 1995 and those applicable to the BOCs' long distance businesses today and in the not-too-distance future

- AT&T was not in 1995 and is not today a dominant carrier in the *local exchange service* market AT&T is required to pay cash out-of-pocket to originate and terminate all long distance calls that it carries from and/or to ILEC customers BOCs, by contrast, at best make non-cash transfer payments *to themselves* for *all* originating access charges

1 SBC Comments, at para 9 *et sec,* BellSouth Comments, at 3, Verizon Comments, at 21-26, Qwest Comments at 9, 13-14, 19

and for a substantial portion — perhaps in excess of 50% — of terminating access charges associated with long distance calls provided by BOC long distance affiliates to BOC customers. In the case of *intraLATA* calls handled by the BOC, as well as inter-LATA calls handled by the BOC following sunset of the Section 272 separate affiliate requirement, the BOC does not even make an internal transfer payment accounting entry for the access services it utilizes As long as access services continue to be priced at large multiples of forward-looking economic cost, the BOCs have both the incentive and the ability to create a price squeeze for their nonaffiliated rivals, something that AT&T could not have done once the BOCs were separated from it in 1984

- In 1995, AT&T had no presence in the local exchange market, even today, AT&T provides local exchange service at retail to a tiny fraction of all residential customers, and serves these customers primarily via UNE-P arrangements leased from ILECs In 1995, AT&T had no ability to bundle local and long distance services into a single service and pricing package; even today, without a consequential local service customer base together with often high UNE rates and the persistent above-cost access charges and other economic entry barriers imposed by the BOCs, AT&T's ability as an economic matter to offer such bundles ubiquitously is limited Moreover, even that ability is threatened to the extent that UNE-P ceases to be available or ceases to be an economically viable service platform for such purposes [2]

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2 As I shall discuss at greater length at para 26 *infra*, bundled offers pose significant risk

(continued. .)

- The rapid decrease in AT&T's long distance market share following implementation of interLATA equal access can be attributed, in large part, to several *affirmative* FCC policy initiatives aimed specifically at bootstrapping rapid OCC growth. Prior to the availability of 1+ presubscription (equal access) in any central office, competing IXCs were offered access services at deep discounts, in excess of 55%, relative to the prices that AT&T was required to pay ILECs for access services Following the implementation of equal access in any central office, customers (for whom AT&T had, up to then, been the default long distance carrier) were sent "ballots" through which they were given the opportunity to affirmatively select a long distance carrier, AT&T or otherwise And for those customers who did not respond to their "ballot," a long distance carrier was selected for them on a random assignment basis, in proportion to the affirmative carrier choices made by those responding to the balloting process In stark

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2. (continued)
for CLECs In addition, the BOCs' efforts to eliminate UNE-P as an economic choice for CLECs and IXCs has intensified in recent months In early May, SBC succeeded in getting legislation passed in Illinois *in just four days following its introduction in the Illinois General Assembly* that directed the Illinois Commerce Commission to issue an Order roughly doubling UNE-P rate levels Illinois Public Utilities Act 13-408, 13-409 enacted May 9, 2003 On June 9, 2003, Federal District Court Judge Charles P Kocoras issued a Preliminary Injunction staying the Illinois Commission's Order *Voices for Choices et al v Illinois Bell Telephone Co et al* Before the United States District Court, Northern District of Illinois, Eastern Division, Docket No 03 C 3290, *Memorandum Opinion*, June 9, 2003 On July 1, 2003, Verizon filed a *Petition for Expedited Forbearance* asking the FCC to forbear from requiring that UNE-P rates be based upon TELRIC and further to require that the BOC, rather than the CLEC utilizing the UNE-P arrangement, be the recipient of all access charge revenue associated with the UNE-P service *Petition for Forbearance From the Current Pricing Rules for Unbundled Network Element Platform*, WC Docket 03-157, Petition for Expedited Forbearance of the Verizon Telephone Companies, filed July 3, 2003

contrast, BOCs were *never* subjected to any sort of balloting as a condition for opening up the local market to competition, and rather than being offered *discounted* rates for unbundled access to BOC local networks, local service entrants have been subjected to UNE rates that often exceeded the BOCs' retail local service prices.[3]

- As of 1995, AT&T's share of the interLATA long distance market had been steadily declining since the 1984 break-up of the former Bell System, and that downward trend was expected to continue. The transition to "equal access" began in about 1985 and was substantially completed by about 1989 Between 1985 and 1995, AT&T's share dropped from 86 3% to 51 8%.[4] Since 1995, it has decreased to the point where in 2001 AT&T controlled only about 37 4% of the interLATA market.[5] In stark contrast, the BOCs' shares are growing — and growing rapidly — in the wake of their receipt of Section 271 in-region interLATA authority In fact, in each of the states in which BOC long distance entry had occurred, the BOC had succeeded in capturing more market share in just 24 months than all of the non-AT&T interexchange carriers — the so-

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3 See, e g Billy Jack Greg, West Virginia Consumer Advocate Division, *A Survey of Unbundled Network Element Prices in the United States*, January 2003, at Table 3. (available at: http //www cad.state wv.us/103Matrix3 pdf)

4 FCC, IATD, *Statistics of the Long Distance Telecommunications Industry*, May 2003, ("*Long Distance Market Share Report*"), at Table 7 Percentages measured on the basis of revenues

5 *Id*

called "Other Common Carriers" ("OCCs") — combined had been able to take from AT&T after *ten years* following the full implementation of equal access.[6]

- In 1995, AT&T had no significant presence in the *intraLATA* toll market at all, and had no presubscribed customers for intraLATA toll service. Although intraLATA equal access is now universally available and has been available generally since about 1999, in regions where the BOC has in-region interLATA authority BOCs and their long distance affiliates often control in excess of 40% of the intraLATA toll market[7] — and that share is likely to grow as the BOCs and their long distance affiliates gain inter-LATA market share, and therefore reclaim customers who switched their intraLATA PIC from the BOC to their interLATA provider.

For all of these reasons, the suggestion by the BOCs and by their consultants that, on a basis of a static market share "snapshot" their existing market power in the long distance market can be compared with that available to AT&T in 1995 is nothing short of ludicrous

9 In theory, Section 272 attempted to simulate for the BOCs' long distance affiliates the separate and BOC-dependent situation of the IXCs As discussed in my June 30 Declaration, the

6 *Id.* From 1989-1999, AT&T lost 27% market share As noted in para 21 *infra*, BOC affiliates are able to gain 30% market share in only twelve months

7 *Id*, at Table 16. For example, Verizon has 46.7% intraLATA market share (based on minutes) in the Mid-Atlantic region, and SBC has 41 4% intraLATA market share in Nevada and California

structural separation requirements of Section 272, had they been implemented as envisioned by this Commission (which they were not, as discussed in my June 30, 2003 Declaration, at paras. 61-70), should have forced the BOCs' long distance affiliates to stand in the same lines and face the same costs as competing IXCs. As the Commission has noted in this FNPRM, it was precisely the presence of these *structural* requirements of Section 272 upon which the Commission had based its prior decision that the BOC affiliates could be classified as non-dominant during their initial three years.[8] However, for the period after those *structural requirements* sunset, the BOCs are now relying upon the Commission's 1995 decision to classify AT&T as non-dominant, arguing that the market conditions extant at that time for AT&T are the same as those confronting the BOCs today. In advancing such contentions, the BOCs ignore the fact that AT&T was, in 1995, subject to far more stringent structural separation requirements than those applicable to the BOCs and their long distance affiliates under Section 272. AT&T had been completely divested from the BOCs, *and controlled no network elements or other resources* that its long distance rivals required in order to provide competing services. Despite this glaring difference, the BOCs seek to draw an analogy from the Commission's market power finding with respect to a *divested* AT&T to a current snapshot of long distance market share held by *integrated* monopoly local carriers. That analogy cannot withstand scrutiny.

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8. *Section 272(f)(1) Sunset of the BOC Separate Affiliate and Related Requirements*, WC Docket No. 02-112, *2000 Biennial Regulatory Review Separate Affiliate Requirements of Section 64.1903 of the Commission's Rules*, CC Docket No. 00-175, *Further Notice of Proposed Rulemaking*, May 19, 2003 ("*FNPRM*"), citing *Regulatory Treatment of LEC Provision of Interexchange Services Originating in the LEC's Local Exchange Area*, 12 FCC Rcd 15756, 15806 (1997) ("*LEC Classification Order*")

10. The structural separation requirements of Section 272, unlike the Bell System break-up, did nothing to mitigate the BOCs' market power in the local market *within their individual local service footprints*. The BOC long distance reentry provisions of Section 271 were premised upon the expectation that if the local markets were *opened* to competition, the BOCs would be unable to exert market power in long distance. However, Section 271 does not condition long distance entry upon any showing that BOC market power has actually been diminished. Attenuation of BOC market power can only come from successful *facilities-based* competitors in the local market that are not forced to rely upon BOC essential inputs to provide services.

The failure of local competition to develop during the three year time period of Section 272 ensures that the BOCs will now be allowed to provide integrated local and long distance service while maintaining control of the local bottleneck.

11. Significantly, but not surprisingly, the irrefutable *fact* (as I discussed at paras 9-22 of my June 30, 2003 Declaration) of persistent BOC dominance and control of the local market was conveniently and completely ignored by BOC Declarants Carlton, Sider and Shampine ("Carlton *et al*"), who limit their "analysis" solely to the superficial comparison of AT&T's *stand-alone* long distance share in 1995 with a distorted projection of BOC *integrated* local/long distance share as of 2005.

12. The local service market is anything but universally addressable by competing CLECs and IXCs. As I noted in my June 30, 2003 Declaration, the latest FCC *Local Competition Report* for end-of-year 2002 puts the ILEC share of access lines, including resale and UNE services

provided to CLECs, at 96.6%.[9] Some three-quarters of *all* CLEC lines utilize underlying services and facilities obtained from ILECs That 96 6% figure is undoubtedly even higher for CLEC mass market residential and small business customers, and actually understates total ILEC facilities-based share by erroneously treating CLEC services utilizing BOC special access as "facilities-based."

13 SBC and Profs Carlton *et al* repeatedly cite a study by Deutsche Bank to support their market share positions [10] These citations, as it turns out, are highly selective Specifically, in terms of the local market, the Deutsche Bank study notes the ILECs' control of bottleneck facilities, and their ability to leverage this control to disadvantage IXCs:

> If we leave aside the issue of capital expenditure where there is clearly a large degree of latitude, the ILECs exert a de-facto monopoly provision of local access, local termination and local private lines This means that the IXCs have very little control over the cost of originating and terminating their voice and data products [11]

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9 Selwyn June 30, 2003 Declaration, at para 11, citing FCC Wireline Competition Bureau, Industry Analysis and Technology Division, *Local Telephone Competition · Status as of December 31, 2002*, Rel June 12, 2003, ("*Local Competition Report*") at Tables 3&4 Calculation was made using the ILEC total lines from Table 4 (which includes ILEC end user lines, resold lines and UNEs) divided by the sum of ILEC total lines and CLEC-owned lines (from Table 3)

10 SBC Comments, at 27 Carlton *et al*, at fn 19-20, paras 27, 43, Table 1, citing Deutsche Bank Industry Update, Wireline - Mid Year Review, May 27, 2003, ("*Deutsche Bank Study*")

11 Deutsche Bank Study, at 68

14 Although Verizon attempts to claim there has been "tremendous growth in both local and access competition over the past six years,"[12] it ignores the finding of Deutsche Bank that this growth is likely to end soon, and perhaps even reverse

> We continue to believe that through changes to the TELRIC calculation and repricing of elements, we should see a gradual rise in UNE-P tariffs, while by the time UNE penetrates around 15-20% of lines, the re-seller model should start running-out of steam We therefore continue to believe that the eye of the storm has passed, with a declining rate of unbundling though the balance of 2003 and 2004, and some possible win-backs in 2005-2006 [13]

15 With regard to cable telephony, Merrill Lynch and Deutsche Bank both note that it does not pose any immediate threat to the BOCs' local market share Hence, this potential source of facilities-based competition will have no consequential effect in constraining BOC use of their local bottleneck to benefit their long distance services:

> Cable telephony remains a substantial long term challenge for the RBOCs in our view However, given the recent investor concerns over the balance sheet of many cable companies, cable telephony competition could be muted near-term if cable companies direct their efforts to their basic video offerings conserving capex and boosting cash flow *We estimate that cable telephony*

12. Verizon Comments, at 16

13 Deutsche Bank Study, at 23 Deutsche Bank raises the possibility that VoIP may someday be competitive with ILEC dial tone services, but even so does not expect that VoIP will enable competitors to compete on equal footing with the BOCs

> *already serves nearly 2% of residential lines, yet only 10% to 15% of homes in the US are cable telephony ready* [14]

Considering the uncertainty of facilities based competition, and the severe limits of resale and UNE based competition, the BOC control of the local bottleneck remains secure for the foreseeable future

16 BOC local market power is confirmed by several recent Verizon's pricing moves. Verizon has recently asked for (and received) local price *increases* in New York and Massachusetts,[15] and has made similar proposals in several other states.[16] Indeed, despite the reductions in Verizon's intrastate access charges in Massachusetts that accompanied these local monthly rate increases, Verizon has just *increased* its Massachusetts intraLATA toll rates by *more than 30%!*[17] Were Verizon truly facing price-disciplining local competition, it is unlikely that it would *or could* unilaterally raise these prices without driving away customers —

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14. Merrill Lynch, *BellSouth Corp*, January 27, 2003, at 4

15 Verizon Press Release, *New York PSC Approves Verizon Regulatory Plan, Company Announces First Basic Rate Increase in 11 Years,* February 27, 2002 Verizon Residential Billing Insert, "Verizon Extra," June 2003

16 "Verizon Wants to Raise Local Rates," *The Standard-Times*, June 7, 2002, at A10; "Verizon to Change Various Telephone Rates Under Price Cap Filing," Missouri PSC Press Release, available at http //www.psc state mo.us/press/pr0177.pdf.

17 Verizon Extra Billing Insert, Massachusetts Residence, July 2003.

especially in New York and Massachusetts, states with some of the highest (although still small) CLEC penetration rates in the nation [18]

BOC claims of low long distance market share figures are patently false and misleading, even according to their own data, and the Commission must focus upon the 60%-70% residential market share that BOCs have achieved and are likely to achieve in mature long distance markets.

17 Discussions of "the long distance market" that the BOCs and Carlton *et al* present ignore the completely distinct mass market (residential, small business) and enterprise (large business) segments. The Commission has repeatedly found that the mass market and enterprise segments to be separate markets with separate and distinct competitive attributes.[19] The market share figures cited by the BOCs and by Carlton *et al*, and indeed all of the BOCs' discussions of "the long distance market," ignore the Commission's determination that "[i]n this proceeding, we initially consider two broad customer classes the mass market and the enterprise market." Moreover, by stating BOC long distance shares as percentages of the *national* long distance market, the BOCs distort and understate the practical effect of their extraordinarily successful and rapid ramp-up of long distance shares *within their respective Section 271 states or in other*

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18 FCC, IATD, *Local Telephone Competition Status as of December 31, 2002,* June 2003, at Table 7

19 See, e g *In the Matter of Local Competition and Broadband Reporting*, CC Docket 99-301, Rel. March 30, 2000, 15 FCC Rcd 7717, 7754, *Implementation of the Local Competition Provisions of the Telecommunications Act of 1996*, CC Docket 98-98, Third Report and Order and Fourth Further Notice Of Proposed Rulemaking, Rel November 5, 1999, 15 FCC Rcd 3696, 3829

non-BOC operating areas[20] *in which no Section 271 authority was required* SBC has projected, and FCC data confirm, that a BOC residential share in the range of 60% in each of its ILEC jurisdictions is entirely realistic

18 Carlton *et al*, as well as their clients, persist in ignoring these distinctions, and continually quote and point to aggregate long distance market share figures such as those presented in Figure 1 of the Carlton *et al* Declaration Carlton *et al* cite the Deutsche Bank study for the proposition that the BOC share of the (aggregate) long distance market will level off at approximately 27% [21] They conveniently omit any reference to the Deutsche Bank study's conclusions specifically with respect to the *residential* segment

> We are unlikely to win the Nobel Prize for Economics by claiming that the IXCs will lose market share to the benefit of the RBOCs, particularly if the extremely competitive monthly plans currently in the market become a fixture This is demonstrated by a study recently conducted by TNS Telecoms, which shows that the RBOCs as a group have increased their share of residential interLATA minutes by 590 bps [basis points] to 10.6% in the past two years alone When we consider that the majority of s271 clearances were completed over the past six months, then it is clear that the trend can only get worse for the incumbent IXC's Of course, if we were to wrap in intra-LATA toll (a k.a. local toll) where the RBOCs have had no restrictions, then their market share of residential would be even higher.

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20 The specific "Bell Operating Companies" to which satisfaction of the Section 271(c)(2)(B) "competitive checklist" applies are identified at 47 U S C §153(4). SBC's Connecticut subsidiary, SNET, and all of the former GTE companies outside of Pennsylvania and Virginia that were merged with Bell Atlantic to form Verizon, are not "Bell Operating Companies" as defined in the statute.

21 Carlton *et al*, at Figure 1

> Therefore AT&T which has seen its slice of the residential interLATA toll volumes fall from 44 7% to 31 2% in the space of just two years, is facing the twin peril of a declining share of a market which is in itself diminishing. We estimated that the RBOCs will very quickly gain traction in signing up long distance customers, as early progress reports from new market entry over the past 12 months appears to suggest (SBC claimed 12% of the Californian residential market in its first four months of operation)
>
> *We estimate that RBOC long-distance lines (inc Qwest) grow from 17.5 million at the end of 2002, to 30 million at the end of 2003, to 40 million by end-2004, and 48-49 million longer-term* This corresponds to a LD penetration rate of around 40% longer term, across its retail access line base — over 50% in terms of the consumer access base — and 27-28% of total long distance lines in the US [22]

Similarly, Deutsche Bank notes that "[c]learly their [the BOCs'] share of the consumer toll market will be much larger (closer to 50%), with the total brought down by a weaker presence in the corporate and wholesale segments."[23] By selectively noting the Deutsche Bank national market projections together with SBC claims regarding residential long distance share in Texas, Profs Carlton *et al* imply that BOC residential market shares will remain relatively low in "the long distance market." The BOCs, always quick to point out the "conservative" nature of their estimates of *local* competition, in this instance failed to note that Deutsche Bank had characterized its expectations of steady state *long distance* market shares — including the over 50% consumer long distance market share -- as being "on the conservative side "[24]

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22 Deutsche Bank Study, at 84, emphasis in original

23 Deutsche Bank Study, at 87.

24 Deutsche Bank Study, at 99

19 If there is any doubt of the critical role that *local* market power plays in allowing a BOC to capture residential *long distance* share, one need only look to SBC's share of the long distance market in Connecticut, where its SNET affiliate is the dominant local exchange carrier *and* because SNET was never subject to Section 271, has been offering its local service customers long distance service longer than any other large ILEC The FCC's *Long Distance Competition Report* for 2002 gives SBC's residential long distance market share for the seven Northeast states[25] at 6 7% However, as I mentioned in my June 30 Declaration, SBC will only provide long distance service to SBC local customers [26] Since SBC has no consequential local service presence in any of the Northeast states *other than in Connecticut*, it is reasonable to assume that SBC's residential long distance household share *outside of Connecticut* is zero SNET's Connecticut operating territory represents approximately 9.8% of all residential access lines in the seven Northeast states, indicating an SBC/SNET long distance share of approximately 6.7%/ 9 8%, or 68% overall [27] This estimate exceeds the claim made by SBC in January, 2003 that it

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25 The Northeast states include Maine, New Hampshire, Vermont, Massachusetts, Rhode Island, Connecticut, and New York Long Distance Market Share Report, at Notes to Tables 15-17

26. Selwyn June 30, 2003 Declaration, at para 66

27. Residential access lines were estimated by multiplying the total end user switched access lines served by local exchange carriers by the percentage of lines provided to residential and small business customers for each respective Northeast state *Local Competition Report* at Tables 6 and 11 SNET Connecticut 2002 residential access lines from ARMIS Report 43-08, Table III, for year end 2002 Households with multiple lines were assumed to have the same long distance carrier for each line

has acquired a 60% market share in Connecticut [28] A similar calculation can be made for Verizon's former GTE service areas in California and Nevada Although Verizon does not limit its long distance service to its own local customers, Verizon does not market its stand-alone long distance plans to other than its own local customers It is therefore likely that the vast majority of Verizon long distance customers in California and Nevada are also Verizon local customers A similar estimate based upon the *Long Distance Market Share Report* for Verizon' California/ Nevada local service customers suggests that Verizon has also achieved a 68% long distance market share within its California/Nevada local service footprint.[29]

20. Despite these facts, SBC makes the incredible claim that "[t]hough BOC long distance business has been increasing, no one forecasts it will ever hit the roughly 60% level that AT&T had when it was declared to be non-dominant."[30] However, as I noted in my June 30 Declaration, SBC management expressly and specifically stated that *based upon its actual*

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28. SBC Investor Briefing analyst conference call, January 28, 2003.

29 Residential access lines were estimated by multiplying the total end user switched access lines served by local exchange carriers by the percentage of lines provided to residential and small business customers for California and Nevada *Local Competition Report* at Tables 6 and 11 Total Residential Lines estimated at 20.156-million. Verizon California and Verizon Northwest California and Nevada residential access lines from ARMIS Report 43-08, Table III, for year end 2002 (3 164-million) GTE lines account for 15 7% of residential lines in California and Nevada 15 7%/10.7% results in 68 2% long distance share. Households with multiple lines were assumed to have the same long distance carrier for each line

30 SBC Comments, at 25

experience in Connecticut, the Company expected ultimately to realize a market share of approximately 60% in all of its Section 271 states [31]

21 In addition, based upon its conversations with SBC executives, Bear Stearns notes that "SBC assumes that it can achieve 30% [consumer] market share 12 months after entering a new market and is targeting long run (3-4 years) penetration rate in the 60%-70% range."[32] Obviously, SBC's statement to the Commission that "no one" has made such a forecast is more than merely disingenuous, it is an out-and-out falsehood

The BOCs control of the local bottleneck gives them monopoly market power with respect to bundled local/long distance service packages.

22 Deutsche Bank notes that the ability to provide bundled services is a "key competitive advantage in the telecom industry "[33] Despite its immense importance, however, Carlton *et al* *completely ignore the existence of local/long distance service bundles* when discussing the future of the long distance market Drs Carlton *et al* cite the importance of wireless, VoIP, even e-mail as reasons for the declining total revenues of the long distance market, but completely fail to

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31 Selwyn June 30 Declaration, at para. 37, citing Statement of Edward Whitacre, CEO, SBC Communications, Transcript, April 24, 2003, SBC Conference Call Addressing First Quarter 2003 Earnings

32 Bear Stearns Equity Research, *SBC Communications Inc (SBC-24 88) – Outperform*, September 10, 2002

33. Deutsche Bank Study, at 54

note that part of that decline is a direct consequence of BOC offerings of bundled local and long distance services Carlton *et al* acknowledge the decline in stand-alone long distance minutes and thus long distance revenues, but ignore the role played by the BOCs themselves in cementing this fundamental market change in the wireline market. As noted by Deutsche Bank,

> RBOCs are commoditizing long distance within the consumer bundle, resulting in significant pressure on revenue yields and rapidly reducing the overall size of the long-distance switched market .. we estimate that a market worth $87bn in 2001 has already declined to $66bn in 2002, and is likely to fall towards $40bn by the end of the decade. Indeed, the position might be even worse, as indicated by some of the recent RBOC pricing trends, with long-distance included as part of the overall bundle for as little as $5 per month [34]

23 Beginning with the break-up of the former Bell System in 1984, telecommunications pricing and purchasing has been separated as between local and long distance services. The BOCs' long distance entry is fundamentally altering this paradigm By offering "unlimited" long distance calling at an almost negligible pricing increment vis-a-vis local service — a pricing incremental that frequently falls short of the out-of-pocket access charges that a rival IXC would be forced to pay to provide a comparable quantity of long distance calling — the BOCs are fundamentally reshaping mass market telephone service into what some have called an "all distance" model in which carriers that offer "less than all" of the components of such "all distance" packages will be relegated to the lowest end of the customer spectrum. And by exploiting their captive, near-ubiquitous local service customer base, the BOCs are able to

34 Deutsche Bank Study, at 34.

extend their local market dominance into long distance and make a large portion of residential customers enormously more difficult to address, as a practical matter, by carriers that do not have the local service incumbency advantages uniquely available to BOCs.

24 Indeed, the BOCs' ability to engage in this service bundling strategy arises directly from several critically important competitive advantages that have been expressly conferred upon them by Congressional and FCC public policy initiatives:

(a) BOCs are able to set and maintain access charges at large multiples of forward-looking incremental cost.

(b) When BOCs provide long distance service on an integrated basis with local, they do not purchase access services from themselves and do not "pay" themselves access charges Even though the Section 271 separate affiliate is required to purchase access services and pay the ILEC entity for them, such payments are intracorporate transfers that have no effect upon the corporate "bottom line" and can be — and are — regularly ignored by the BOC when setting retail prices. Imputation rules that are supposed to foreclose such conduct are largely ineffective in preventing the BOC from imposing a price squeeze on nonaffiliated IXCs.

(c) BOCs are afforded unique and preemptive access to their legacy base of local exchange service customers, and are expressly permitted to engage in joint marketing of local and long distance services, resulting in the BOCs' incurring only a small fraction of the customer acquisition costs that nonaffiliated IXCs confront

25 To transition a BOC's local customer to a BOC bundle that includes long distance, all that is needed is for the BOC to add to the incremental cost of providing long distance service, minus above cost access, to the price it already sells to local customers. Such a process is completely seamless to the consumer and without risk to the BOC. A nonaffiliated carrier seeking to compete with a BOC for such "bundled" service packages must be prepared to offer local service at retail, either by deploying its own facilities or by means of BOC-provided resale services or UNEs

26 Deutsche Bank recognized that competitors face significantly higher risks in the bundled market than are faced by BOCs

> Although the bundling strategy is fraught with uncertainties for the RBOCs, the degree of uncertainty facing long-distance (UNE-P) carriers is of a significantly higher order of magnitude. Essentially, what operators like AT&T and MCI are trying to achieve is the "synthetic" or "virtual" RBOC formulae, relying on a mix of UNE-P, UNE-L, re-sale, marketing arrangements with cable operators, etc to access the customer base. These "virtual RBOCs" rely on a mix of low wholesale access prices, their name and reputation in the long-distance market, and the ability to remain flexible and technology-agnostic in selling bundles to customers

> Clearly, the whole formula relies on the continuation of the current wholesale discounts, and the ability to maintain a flexible cost structure Any significant change in the regulatory climate will completely negate this model, as would any significant change in external costs (such as marketing, revenue sharing, etc). At the end of the day, very few re-seller models survived and succeeded anywhere globally, and for good reason. Virtual companies have limited control over their cost structures and ability to enhance quality of service, and indeed do anything else other than discount prices.[35]

Indeed, in the long run, Deutsche Bank dismisses the ability of a UNE provider to compete with a BOC's bundled offerings

> The real problem is not one of legalistic interpretations of Congress's intentions in the drafting of the Telecom Act, but rather that there are glass ceilings to the resale model We believe that these limits are reached when around 25-30% of residential customers have gone into a wholesale relationship. Following this point, consumer apathy combined with a relatively high rate of churn (RBOC win-back programs) should limit further market share gains for the unbundlers This means that meaningful residential local line share gains should be possible over the next 7-8 quarters, but are estimated to peak at 6 5 million longer term
>
> *However 6 5 million local lines is not sufficient to anchor a business that encompasses an estimated 40-45 million pre-subscribed toll customers, that are wide open to RBOC attack* While it could be argued that the RBOCs are acting as resellers in this space (as they purchase wholesale toll capacity from facilities-based IXC's such as AT&T), the reality is that toll is a much smaller share of the pie than the local exchange portion The average residential spend on local exchange services is $36-37 per month, compared to $12-13 for long distance services Therefore the RBOCs have the incentive to completely commoditize the long distance value proposition in the interests of defending their higher value local exchange franchise This is the method in the madness of the extremely competitive RBOC packages in the market, offering inter-

35 Deutsche Bank Study, at 36

> LATA for as little as $0 02 per minute vs prevailing rates for around $0.07-0.09 [36]

The requirements of this "bundled" marketplace, including the reliance of CLEC bundles providers on RBOC local facilities (especially the continued existence of UNE-P and its treatment of access charges), result in unique risks for IXCs and other possible entrants in the market. Bundled services should be considered by this Commission as a market separate from either the local *or* the long distance market These services present specific cost allocation problems well addressed by the granular and service specific cost support data required by dominant regulation.

Verizon claims that the BOCs have not leveraged their bottleneck power in the intraLATA, interLATA corridor, information services, CPE, and wireless markets do not provide probative evidence contradicting the trend toward BOC remonopolization of the long distance market.

27 Verizon's attempt to link the Commission's previously successful efforts at introducing competition into BOC bottleneck monopolies ignores important factors that render any such comparisons meaningless Verizon cites examples of "comparable" markets where the BOCs claim to have lost significant market share, despite their ability to provide these services on an operationally integrated basis with their local offerings

36 Deutsche Bank Study, at 100, emphasis in original

InterLATA Corridor Traffic

28 Under the terms of the MFJ, two "corridors" were established in the New York/New Jersey and Philadelphia/New Jersey metropolitan areas, respectively, within which the BOCs serving these areas (then Bell Atlantic and NYNEX, now Verizon) were permitted to carry inter-LATA traffic. However, upon implementation of interLATA equal access in the mid-1980s, *the so-called "corridor" traffic was subject to the same interLATA PIC as all other interLATA traffic* Seeming to ignore this critically important fact, Verizon notes that Bell Atlantic's ability to provide interLATA corridor traffic on an operationally integrated basis with its local services did not do anything to help it to retain market share, which Verizon claims has by now dropped to insignificant levels [37] However, in the case of "corridor" calling, customers were *never* afforded the ability or opportunity to specify a separate "corridor" PIC. Hence, unless the caller made a special effort to "dial around" her selected interLATA PIC by using a 101-XXXX access code to use BOC "corridor" service (which among other things would require that the customer accurately identify particular calls as falling within the "corridor"),[38] those calls would automatically be routed to the caller's interLATA PIC

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37 Verizon Comments, at 13

38. Except for the New York end of the New York/New Jersey "corridor," which consisted specifically of the five New York City boroughs that could be easily identified by the '212' and later the '212' and '718' area codes (thus potentially enabling northern New Jersey customers to determine that calls made to these area codes could be dialed as "corridor" calls), the northern New Jersey, Camden and Philadelphia portions of the corridors were *subsets* of the (then) '201', '609', and '215' area codes, respectively, making it extremely difficult for a customer dialing a "corridor" number to readily associate a given call to these NPAs as presenting a BOC "corridor service" option

IntraLATA Toll

29 Verizon claims that BOC provision of intraLATA toll operations have always been provided on an unseparated basis and yet notes that the BOCs have lost substantial intraLATA market share since intraLATA equal access was implemented nationwide around 1999. Verizon cites this loss of BOC market share as further evidence that the BOC has no ability or incentive to leverage bottleneck facilities to prevent competition [39] The evidence shows otherwise

30 Dialing parity does exist today with respect to intraLATA toll, and while competition is present, BOCs continue to dominate this segment. As discussed at considerable length in my August 5, 2002 Declaration in the Section 272 Sunset proceeding,[40] intraLATA toll/local integration permits the BOCs to provide end-to-end service *without utilizing switched access services* of the type that are provided to IXCs, and in so doing gain cost and operational advantages that have enabled BOCs to offer retail intraLATA services at or below access charge levels In fact, Verizon witness Dr Tardiff appears to concede this point in the Declaration cited by Verizon, where he notes that IXCs "had to compete against inexpensive local calling within the LATA"[41]

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39 Verizon Comments, at 13

40 *Section 272(f)(1) Sunset of the BOC Separate Affiliate and Related Requirements,* WC Docket No 02-112, Declaration of Lee L Selwyn, filed August 5, 2002, at paras. 58-59.

41 *In the Matter of Petition for Forbearance From The Prohibition of Sharing Operating, Installation, and Maintenance Functions Under Section 53.203(a)(2) Of The Commission's Rules,* CC Docket No 96-149, Declaration of Timothy J. Tardiff attached to Reply Comments of Verizon, filed Sept 24, 2002, ("Tardiff Declaration") at para. 8 In New Jersey, for example,
(continued. .)

Although IXCs have been successful in encouraging many customers to select the IXC for both intraLATA and interLATA service, the fact that (prior to receiving Section 271 authority) the BOCs continued to provide intraLATA toll to nearly half of all local service customers *even though 100% of those customers were required to affirmatively select a separate interLATA carrier* serves to underscore the enormous value of the BOCs' incumbency and operational integration [42]

31 Significantly, BOC entry into the *interLATA* market appears to have reversed the downward trend the BOCs had been experiencing with respect to *intraLATA* market share. Verizon's

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41 (continued)
Verizon customers can purchase "Selective Calling Service" affording up to eight (8) hours of flat-rate calling (and low per-minute rates for usage in excess of that level) to nearby exchanges that would otherwise be subject to toll charges. Rates for Selective Calling service may be as low as $5 83 for a 24 hour block-of-time to three nearby exchanges, amounting to as little as $0 004 per minute (Verizon New Jersey Inc, Tariff B P U.- N.J No 2, Exchange and Network Services, Sixth Revised page 21, effective June 18, 2001). Verizon's intraLATA switched access charges that an IXC would pay to provide an intraLATA call in New Jersey amount to $0 017868 Verizon New Jersey Inc B P U. NJ Tariff No 2, Exchange and Network Services, Sixth Revised Page 21, Effective June 18, 2001 Similar optional expanded local calling plans can be found in other states, including Massachusetts (New England Telephone and Telegraph Company, MADTE No 10, Exchange and Network Services, Part A Section 10, effective July 14, 1999)

42 Dr Tardiff put BOC intraLATA toll *revenue* shares at roughly 45% Tardiff, at fn 10 Since IXC shares include services furnished to customers over special access facilities leased from ILECs, the BOC share of the "dial-1" intraLATA toll market is undoubtedly well in excess of that 45% level Additionally, the "toll" revenues cited by Tardiff *exclude* BOC revenues gained from optional expanded *local* services that themselves compete with IXC-provided intraLATA toll and that BOCs are able to provide at below-access-charge prices specifically because of their ability to integrate the access and interexchange functions

3rd Quarter 2002 Report indicates that BOC interLATA authority is halting the effect of intra-LATA dialing parity on competition in the intraLATA market, reporting a net gain in intraLATA customers for each of the past five quarters [43] More generally, since it is almost inconceivable that a customer would select a BOC for interLATA service while choosing a *non-BOC* carrier for intraLATA calling, the BOCs' share of the interLATA long distance market in "271" states represents a *lower bound* of the likely BOC intraLATA share. Thus, if the BOC interLATA share can be expected to reach the 60% range and assuming that roughly half of all customers who have selected a non-BOC IXC for interLATA calling *continue to select the BOC as their intraLATA PIC*, then the BOC intraLATA share could well increase back to a level of 80% or higher

Information Services

32 Verizon observes that while BOCs are permitted to offer "information services" on an integrated basis with no OI&M separation requirements, they nevertheless maintain only a small share of the information services market For example, Verizon (again citing Dr. Tardiff) puts BOC (and GTE) shares of "voice mail" services at only 15% and notes that there are "hundreds of non-affiliated Internet service providers (ISPs) "[44]

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43 *Verizon Investor Quarterly*, 3rd Quarter 2002, October 25, 2002 ("*Verizon 3Q Report*"), at 5

44 Verizon Comments, at 14-15

33 In claiming that BOCs maintain only a 15% share of voice mail revenues, it is likely that Dr Tardiff had applied an unduly expansive market definition that includes segments that BOCs do not specifically target or even serve With respect to voice mail, BOCs are primarily engaged in *retail*-level individual mailbox offerings targeted to BOC residential and single-line business customers BOCs do not typically compete for voice mail business from purchasers of multiple mailboxes, such as PBX users BOCs also do not typically compete for voice mail business from paging or CMRS carriers or from CLECs. The primary value of BOC operational integration with respect to voice mail lies in the single mailbox services provided to the residential and small business market, and BOCs appear to dominate this sector [45]

34 Dr Tardiff does, however, conveniently *ignore* one critically important aspect of BOC-provided ISP access — ADSL — in which BOCs are clearly exerting market power and leveraging their control of the local market into the adjacent competitive market for Internet access In fact, BOCs have come to *dominate* the growing ADSL-based "high-speed Internet access" market [46] The FCC last February announced details of the so-called *Triennial Review* order in which, among other things, the requirement that ILECs make the high-frequency

45 Verizon notes that its "bundles" services are driving penetration of "basic" vertical features such as Caller ID, and Voice Mail According to Verizon, over 19% of consumer customers subscribe to a bundle. Many more are likely to subscribe to BOC voice mail separate from a bundle Verizon 3Q Report, at 5

46 As of December 31, 2002, the RBOC share of ADSL lines was 86.3%. As a percentage of high speed lines, the BOCs provided 32.2% of all high speed lines FCC, IATD, *High Speed Services for Internet Access Status as of December 31, 2002*, June 2003, at Table 5